

The Depreciation of the Pound Sterling

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IN CONTRAST with the abrupt rise in sterling exchange following the outbreak of the World War in 1914, the beginning of the present European conflict was attended by a continuation of the fall of the pound which commenced early in 1938.¹ The recent depreciation of the pound sterling involved a decline in the dollar values of the currencies of countries which take three-fifths of United States exports and which supply one-half of United States imports. These facts suggest the potential significance of the fall of the pound for foreign trade. It is perhaps not too much to say that the decline of sterling and associated currencies at the end of August is one of the most important of the early effects of the war in its possible repercussions upon the course of business in this country. The consequences of the fall of the pound must be interpreted, however, in the light of the basic forces at work, as well as of the circumstances which immediately preceded its depreciation.

¹ In 1914 the pound rose abruptly during the first weeks of the war from its approximate parity with dollars, \$4.87, to \$7 as a result of a combination of circumstances. The United States, then a debtor country, was obliged to meet substantial maturing commitments in London at the very time that British and other foreign investors in domestic obligations were attempting to liquidate their holdings and convert the proceeds into sterling and at the very time that the disruption of shipping stopped both the shipment of cotton, a principal source of sterling bills, and the export of gold. When measures were taken to rectify the situation, the pound fell as sharply as it rose and reached \$4.56, well below its former parity, in September 1915. Early in 1916 it was pegged at \$4.76 for the duration of the war.

The Fall of the Pound.

In the middle of February 1938 the pound was quoted in New York at \$5.04. At the beginning of September 1939, following the imposition of exchange restrictions, the Bank of England fixed its official selling rate for dollars at \$4.02; and some transactions took place in the New York market during the month at prices as low as \$3.75. The depreciation of sterling over this 18-month period represented a loss of a fifth of its dollar value. (See table 1 and fig. 6.)

The sharp breaks in quotations for the pound during 1938 and 1939, as opposed to the general downward trend, were unmistakably associated with war scares in Europe and with the resulting movement of funds from London to New York. In March 1938, at the time of the annexation of Austria by Germany and the Polish demands upon Lithuania, the rate fell below \$4.95 from \$5.02 at the first of the month. The events leading up to the Four Power conference at Munich were the occasion for a precipitous drop to \$4.61 on September 28 from \$4.86 on August 31. A loss of 13 cents between November 7 and November 26 accompanied the renewed tension over the dismemberment of Czecho-Slovakia. Finally, the decline at the end of August 1939 from \$4.68 to \$4.12 was a response to the imminent outbreak of European war.

Table 1.—The Position of Sterling, 1938-39: Dollar Rates of Exchange, Gold Movements, and Gold Reserves

Month	Dollar rates of exchange (in cents per pound)			Net gold exports or imports (—) (in millions of dollars)			Gold reserves (in millions of dollars)		
	Spot (average)	Forward discounts (range)		To (or from) United States		To (or from) all countries	Bank of England	Exchange equalization account	Total
		30 days	90 days	United States data	United Kingdom data				
1938									
January.....	499.98	0.25-0.31	0.72-0.81	(1)	-1.5	-27.2	2,689		
February.....	501.80	.22-.31	.63-.78	(1)	-3.5	-51.4	2,689		
March.....	498.45	.22-.34	.72-.81	31.4	35.5	-79.0	2,689	1,489	4,178
April.....	498.12	.19-.22	.56-.69	35.4	18.5	-53.2	2,689		
May.....	496.73	.16-.25	.56-.75	2.9	5.2	-97.5	2,690		
June.....	495.80	.19-.31	.31-.69	20.6	20.8	-59.6	2,690		
July.....	492.91	.19-.25	.31-.69	5.0	10.5	-24.1	2,690		
August.....	488.08	.25-.31	.63-.75	91.2	93.7	73.1	2,690		
September.....	480.35	.31-.38	.75-2.50	378.0	300.0	261.1	2,690	759	3,449
October.....	476.85	.28-.31	1.00-2.06	443.4	308.5	210.2	2,690		
November.....	470.75	.28-.63	1.05-1.81	99.1	105.2	95.5	2,690		
December.....	467.03	.09-1.25	1.69-2.43	101.7	97.4	64.7	2,690		
1939									
January.....	466.94	.36-.64	1.38-2.50	52.1	50.8	39.5	2,102		
February.....	468.57	.31-.50	1.06-1.53	165.4	100.2	145.0	1,042		
March.....	468.54	.38-.88	1.19-2.50	256.0	300.8	260.0	2,106	1,732	2,798
April.....	468.05	.09-1.00	2.06-3.38	384.9	357.5	121.2	1,056		
May.....	468.13	.41-.73	1.31-2.63	302.7	257.8	294.1	1,057		
June.....	468.24	.38-.75	1.31-2.25	128.2	127.3	51.6	1,057		
July.....	468.15	.44-.69	1.56-2.00	177.8	182.1	147.3	2,162		
August.....	461.07	.53-2.25	1.69-5.00	163.7	234.4	328.3	1,162		
September.....	369.51	1.00-2.00	3.00-5.50	162.5			1		

¹ Reported net exports were negligible.

² Gold valued at \$1,048,000,000 was transferred from Bank of England to Exchange Equalization Account on Jan. 6; \$20,000,000 was transferred back to Bank of England on Mar. 1, and \$94,000,000 on July 12; \$1,102,000,000 was transferred from Bank of England to Exchange Equalization Account on Sept. 6.

Source: Board of Governors of the Federal Reserve System.

In the interval between March and late August 1939, the dollar-pound rate deviated only fractionally from \$4.68. On August 25, after meeting large demands for dollars at the cost of substantial losses of gold over a period of several weeks, the British authorities withdrew from the market. Quotations for sterling in New York fell to \$4.12 on August 28, then recovered to \$4.40 at the end of the month. Renewed weakness carried the rate to \$4.075 on September 5, when it was announced

of sterling above the Bank of England's selling rate before the close of the month. In the middle of October, however, pounds were again exchanged for dollars in New York at quotations below \$4.02.

The events of the past 2 years indicate that large-scale transfers of liquid funds, coinciding with political developments in Europe, were the occasions for successive declines in the value of the pound. The depreciation of sterling might be attributed to the erratic movement of

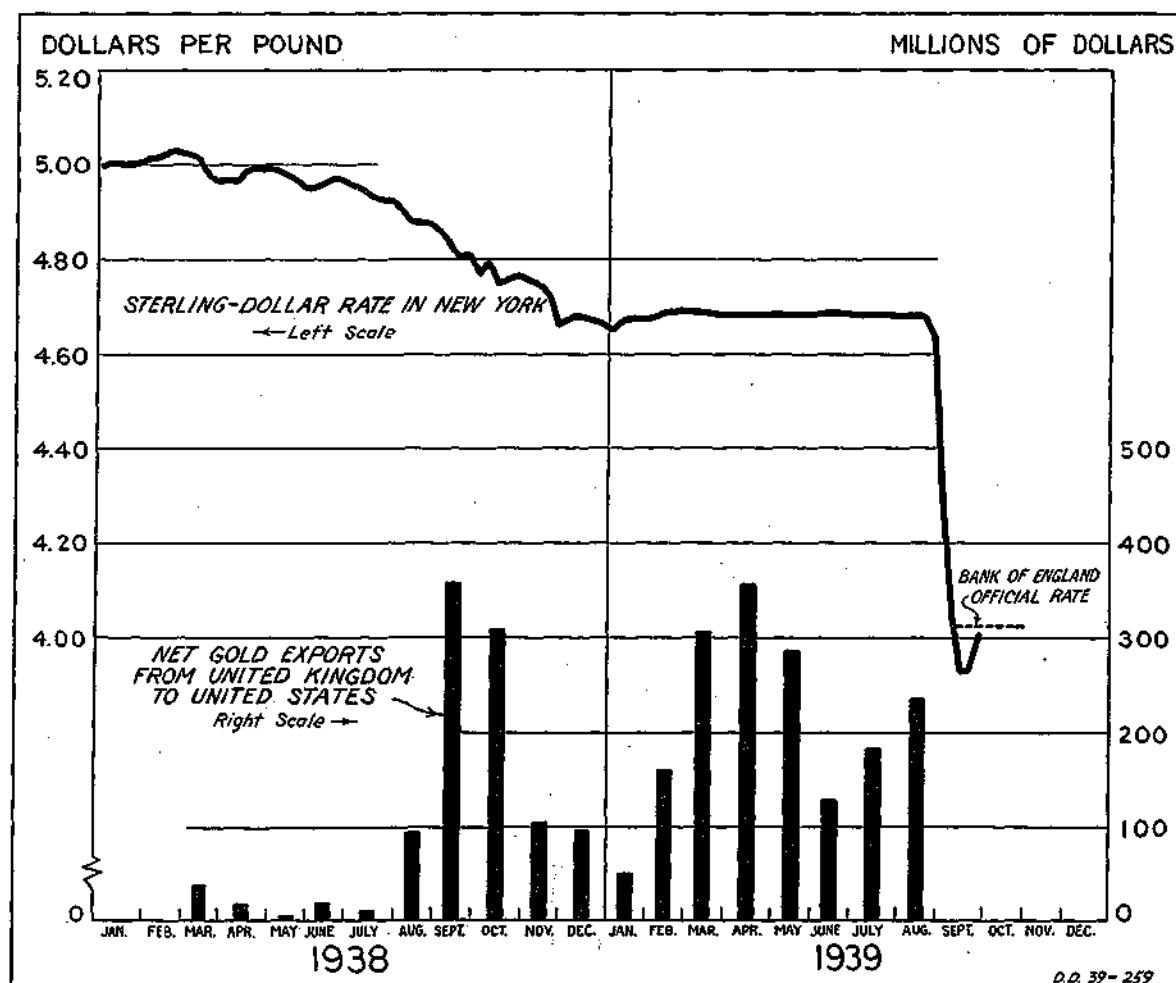


Figure 6.—Sterling Exchange in New York by Weeks and Net Gold Exports from the United Kingdom to the United States by Months, 1938 and 1939. (Board of Governors of the Federal Reserve System.)

that the official selling and buying rates of the Bank of England for the transfer of American-owned pre-war sterling balances and for approved trade transactions between the United States and the Empire would be fixed at \$4.02 and \$4.06. (The buying rate was lowered to \$4.04 on September 14.) Offerings of pounds in this market rather than in London, because of temporary confusion regarding the privileges of American holders of sterling, and offerings here by foreign holders of sterling who were not entitled to these privileges brought some trading to New York. Prices varied considerably and ranged down to \$3.75 on September 18. The subsequent rise in quotations brought the price

capital under purely speculative influences without regard to commercial factors. It is significant, nevertheless, that the pound had been vulnerable to speculative pressure since early in 1938 and that insufficient commercial support was forthcoming when the rate weakened to reverse the downward trend. The support for the currency came largely from another source—that is, from gold operations of impressive size.

The Loss of Gold.

At the end of March 1938 the combined gold holdings of the Bank of England and the British Exchange Equalization Account were \$4,178,000,000. (See table

1.) Of these reserves a very large part represented a deliberate accumulation against the short-term funds which had been flowing into London over the several preceding years. At the end of March 1939, the last date for which comparable data are available, their holdings had decreased to \$2,798,000,000. These gold losses, amounting to \$1,380,000,000, had their approximate counterpart in exports to the United States from the United Kingdom, which, according to British statistics, aggregated \$1,538,000,000 during the same period. Further heavy losses of gold since March are indicated by shipments from London to New York, which totaled \$1,189,000,000 in the 5 months ended August 31. Some portion of this huge transfer of gold must be regarded as the expatriation of British and other foreign-owned gold reserves to be placed under earmark in the United States, but the actual amount of gold which passed from British ownership or from British control was extraordinarily large.

The strength of the pressure upon sterling at various times during the past 2 years, as well as the willingness of the British authorities to release gold in support of the currency, may be gauged roughly by the size of gold shipments from London to New York. In the first part of 1938 the movement of gold was small or negligible. During September and October, as the Sudeten crisis ran its course, the transfer involved \$669,000,000, despite the fact that the sterling-dollar rate was permitted to fall sharply when the tension was at its height. After ranging from around \$100,000,000 in November and December to \$50,000,000 in January 1939, the movement gained momentum. (See fig. 6.) It increased sharply to \$160,000,000 in February and to \$307,000,000 in March, in the course of which the pound was pegged at approximately \$4.68. This attempt to maintain an almost rigid dollar value for the currency was followed by gold exports to the United States of \$358,000,000 in April, of \$288,000,000 in May, and by additional losses aggregating \$544,000,000 in the period from June through August.

These gold losses over an extended period of time and the acceleration of the outflow during 1939 were followed late in August by the decision on the part of the British authorities to allow the pound to depreciate. Further measures of exchange control were instituted a week later, when the pound was pegged at \$4.02.

Regarding the level of the exchange rate, there were clear advantages to maintaining the pound at a high level in order to reduce the cost in pounds of acquiring war supplies outside the sterling area and to obviate a direct influence toward an internal rise in prices. This aspect of the matter runs through the whole problem of financing a war: through the problem of raising tax revenues and loans and the problem of keeping the

national debt within manageable limits. If the British Government had been prepared to institute rigid exchange control prior to the declaration of war, the value of the pound could have been fixed at the existing level (as it was, substantially, during the World War). As matters stood, however, the defense of the pound at the stabilized rate of \$4.68 was resulting in the dissipation of gold and foreign-exchange resources—resources which had been acquired, it should be noted, in consequence of an inflow of capital funds.

The question as to whether the depreciation of the pound will result in significant competitive advantages for British goods and services in foreign markets is not easy to resolve. It must be recognized in this connection that the downward adjustment of a currency may be an appropriate device for the purpose and, as will be developed later, that the balance of payments of the United Kingdom, according to Board of Trade estimates, has shown substantial deficits on trade and service account in recent years. Even before the outbreak of war, the rearmament program had entailed the diversion of manufacturing facilities from production for export to production for national defense. Control measures imposed to aid in the prosecution of the war included a provision for export licenses. The extent to which price concessions resulting from exchange depreciation were regarded as either necessary to maintain foreign markets for what products the United Kingdom can spare or as desirable in the case of products for which British countries are the principal or sole sources of supply is a matter for conjecture.

The Mobilization of External Resources.

In January 1939 the Bank of England transferred £350,000,000 (\$1,648,000,000) of gold to the Exchange Equalization Account. This action was taken in conjunction with measures designed to curb speculation in exchange and in gold and served to replenish the Account's holdings of gold, which had been seriously depleted during the last half of 1938. In September the mobilization of gold reserves was completed by the transfer of the remainder of the gold in the Bank of England to the Exchange Equalization Account and by the requirement that all gold (and foreign exchange as well) held by persons resident in Great Britain be sold to the Treasury. The export of gold was prohibited.

Since the amount of gold in the possession of the Exchange Equalization Account at the time the second transfer was effected is not known, the aggregate value of the gold at the disposition of the British Government cannot be reckoned with any accuracy. At a minimum it includes the holdings of the Bank of England at the end of August, \$1,162,000,000, in addition to gold in

the Account.² A portion of these reserves had already been expatriated to earmarked accounts in the United States and Canada or been purchased in South Africa and earmarked there. So long as there is no change in the gold policy of the United States Treasury, the balance, as well as the amounts held under earmark, can be surrendered to this country at the discretion of the British authorities.

Finally, in respect of gold, production in British countries (excluding Canada), placed at \$580,000,000 in 1938, might at first glance be considered as an added resource. Nevertheless, new production, plus dis-boarding by India, has not been sufficient in recent years to cover net payments by British countries to the rest of the world on account of trade in goods and services.³ Whether it will be possible so to reduce ordinary commercial payments to non-British countries or so to increase ordinary commercial receipts from such countries that gold currently produced can be devoted in part to extraordinary war needs rather than wholly to usual peace-time requirements is a matter for conjecture.

In April 1939 an unofficial ban on the purchase of foreign securities was imposed by the British Government, and in June a census was taken of American and Netherland securities held by British investment trusts and insurance companies. In August, restrictions were placed on the sale or transfer of securities payable in the currencies of nine countries, one of which was the United States. At the same time, holders of such securities were required to register their holdings with the Bank of England. Thus the British authorities are fully prepared, if it should be found necessary, to utilize overseas investments to finance purchases of foreign materials.

British investments in the United States have been estimated by the Department of Commerce at \$2,300,000,000 to \$2,400,000,000. The total covers dollar balances, including official balances, reported at \$600,000,000 at the end of June 1939, and private long-term investments amounting to \$1,700,000,000 to \$1,800,000,000. Of the latter, British-controlled American enterprises represent an investment of nearly \$700,000,000; the remainder, with the exception of certain miscellaneous investments, consists of holdings of stocks and bonds. According to unofficial sources,

aggregate British long-term overseas investments were £3,800,000,000 at the end of 1936. Approximately 60 percent of the investments were in British countries; 40 percent were in foreign countries, including the United States.

Significance of the Fall of Sterling.

Trade returns for recent periods show that well over half of the imports into the United Kingdom originated in countries belonging to the sterling-currency bloc and that more than two-thirds of the exports from the United Kingdom were destined to the same countries. The sterling exchange area has, however, been reduced as a result of the fall of the pound in terms of dollars and of gold. For example, the currencies of the Scandinavian and Baltic countries broke their previous ties with sterling in September, although all weakened against dollars. Quotations for the Canadian dollar in New York fell by approximately 10 percent during the month, as compared with the 15-percent decline in the value of the pound. Other British countries, including Australia, New Zealand, India, and South Africa, kept their currencies rigidly pegged to sterling in the course of its decline after August 24; and, among non-British units, the French franc and the Japanese yen depreciated in terms of dollars to the same extent as the pound. The belga, which has a fixed gold value, also the guilder and the Swiss franc, both of which had previously broken away from sterling, fluctuated within narrow limits around their prevailing dollar equivalents following the depreciation of the pound at the end of August.

Trade between the United Kingdom and countries whose currencies remained linked with sterling, as well as trade among such countries, is affected by the depreciation of sterling only because of the alteration in the terms of trade between the sterling exchange area and the rest of the world. Even with the defections from the sterling currency bloc taken into account, a large proportion of the trade of the United Kingdom (approximately 45 percent of the imports and nearly 60 percent of the exports, according to trade returns for recent periods) will still be carried on with countries in the sterling exchange area; and, apart from war requirements, the proportion would be expected to increase as a result of the depreciation of the pound. Moreover, the greater self-sufficiency of the British Empire in essential supplies and the existence of substantial accumulated stocks of war materials are factors to be considered in appraising the demand for commodities from non-British countries.

From the point of view of the United States, the fall of the pound involved a decline in the dollar values of the currencies of countries which take three-fifths of United States exports and which supply one-half of United States imports. Furthermore, the terms of competition between American products and Empire products within the sterling exchange area have been altered, for the present, in favor of the latter.

² The Exchange Equalization Account held gold valued at \$1,732,000,000 at the end of March. Between the end of March and the end of August net exports of gold from the United Kingdom were reported at \$942,000,000. The actual loss of gold by the Account during this period could be reckoned by adding to the figure for net exports (1) imports of gold involving no change in ownership (as, for example, in the case of the shipment of central bank reserves to London for safekeeping) and (2) purchases of gold in the London market for hoarding purposes, and deducting (1) gold exported by the Account to be placed under earmark abroad or purchased abroad and held under earmark, (2) exports of gold involving no change in ownership (as, for example, in the case of central bank reserves transferred to New York for greater safety), and (3) sales of gold in the London market out of private hoards. The data necessary for the calculation are, of course, not available; but it is probable that the deductions would exceed the additions by a considerable margin for the period in question.

³ See de Vegh, Imro, *The Pound Sterling* (New York: Scudder, Stevens, and Clark, 1939), p. 34.

It may be taken for granted that the British and Empire authorities will seek to maintain and increase export trade between the sterling area and the rest of the world to the degree consistent with wartime exigencies. Nevertheless, whatever judgment might be rendered under other circumstances upon the efficacy of currency depreciation as a stimulus to exports, the difficulties of supply and transport are likely to preclude any increase in exports from the United Kingdom. The position of Empire countries, which are important suppliers of raw materials to the world market, is clearly different; even so, the extent of industrial recovery in countries outside the sterling area, especially in the United States, may have a much greater effect upon their export trade than price adjustments growing out of the depreciation of sterling.

On the side of imports into British countries, the fall of the pound has had the immediate consequence of increasing their cost in terms of the currencies of the sterling bloc. This circumstance will serve to reinforce import restrictions and higher excise taxes upon imported products. At the same time, as pointed out above, it raises the sterling cost of foreign materials and gives impetus to the increase in domestic prices and the cost of living. The actual course of import trade into the United Kingdom and into British countries certainly

cannot be projected into the future with any confidence, although it would seem that imports of nonessential goods will be sharply curtailed. Purchases of supplies necessary to the prosecution of the war or to the support of the civilian population, on the other hand, may be greatly expanded.

Balances of Payments of the United Kingdom and the Sterling Area.

As is well known, the balance of payments of the United Kingdom shows an excess of merchandise imports which are paid for by the sale of services and by the income from British overseas investments. In only 1 year since 1931 has there been an excess of receipts on current account—that is, an excess of receipts for services (including the return on overseas investments) over payments for goods imported. (See table 2.) In each of the years 1937 and 1938, the excess of payments on current account was placed at £55,000,000. Since there have been no additions to British gold holdings over this period as a result of net receipts from abroad on trade and service account, the influx of gold into the United Kingdom in 1932–37 must have had as its counterparts an inflow of foreign funds, on the one hand, and a repatriation of British capital, on the other.

Table 2.—Partial Balances of Payments of the United Kingdom and the Sterling Area, 1931–38
[In millions of pounds]

Item	1931	1932	1933	1934	1935	1936	1937	1938
UNITED KINGDOM								
Excess of merchandise imports (payments to other countries).....	408	287	263	294	261	345	442	377
Net income from overseas investments; net income from sale of services (receipts from other countries).....	304	230	263	287	293	327	356	322
Net payments to other countries on current account.....	104	51	0	7	132	18	56	55
STERLING AREA (INCLUDING UNITED KINGDOM)								
Excess of merchandise imports (payments to countries outside sterling area).....	474	298	252	295	296	321	441	472
Net income from services, including income from overseas investments (receipts from countries outside sterling area).....	168	113	145	165	171	200	260	202
Net payments to countries outside sterling area on current account.....	306	185	107	130	124	121	181	270
Gold production and gold dishoarding.....	95	147	127	137	130	126	119	125
Excess of payments on current account over gold production and dishoarding.....	211	38	120	17	16	15	62	145

¹ Excess of receipts.

Source: Data for the United Kingdom are official estimates; those for the sterling area are from de Vegh, *The Pound Sterling* (New York: Scudder, Stevens, and Clark, 1939), pp. 116–130. Because of inherent difficulties of compilation and estimation, the data are subject in either case to a considerable margin of error.

As a result of the building up of foreign balances in London, a considerable part of the gold stock held in the United Kingdom came to be hypothecated to foreigners and was subject to withdrawal at any time. Furthermore, the deficits arising from the exchange of goods and services indicate that the United Kingdom was either drawing upon British capital invested overseas to balance its international accounts or else utilizing foreign funds of an essentially short-term nature for the purpose—whether one or the other cannot be ascertained in the absence of adequate statistical data. If the first possibility prevailed, the mass of overseas investment was being depleted in the face of other influences tending to reduce their yield; if the second, a short-term liability was being created without a corresponding addition to gold reserves,

A partial summary of transactions between the whole sterling area⁴ and the rest of the world, which is in many respects more fundamental for the position of sterling than the balance of payments of the United Kingdom alone, indicates that a principal support for the pound lies in the maintenance of an external market for gold at its established price. Even with gold production and gold dishoarding set against the excess of payments by the sterling area to the rest of the world on current account (that is, for goods and services) there has been in recent years a very substantial deficit to be covered in other ways. (See table 2.)

⁴ For balance-of-payments purposes, the sterling area is defined to include countries which keep all or an important part of their monetary reserves in the form of sterling balances. See de Vegh, *op. cit.*, p. 4 et seq.